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No. 01-147

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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QUESTION PRESENTED

Whether a stockbroker's fraud is "in connection with the * * * sale" of securities under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so.

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 238 F.3d 559. The memorandum and order of the district court granting the Securities and Exchange Commission's motion for summary judgment (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 26, 2001. A petition for rehearing was denied on March 26, 2001 (Pet. App. 51a). On June 16, 2001, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including July 24, 2001. The petition was filed on that date and was granted on November 8, 2001. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTE AND RULE INVOLVED

The texts of 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5 are reproduced in the appendix to the petition for a writ of certiorari (Pet. App. 52a-53a).

STATEMENT

1. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b) (*reprinted in full at* Pet. App. 52a). SEC Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5 (*reprinted in full at* Pet. App. 52a-53a).

2. In 1987, respondent Charles Zandford, a stockbroker, convinced William Wood to open a joint brokerage account for Wood and his daughter, Diane Wood Okstulski. Wood was an elderly man in poor health, and his daughter was both mentally retarded and mentally ill. Wood and Okstulski (the Woods) entrusted respondent with $419,255 to "conservatively invest" in his discretion. Respondent, however, methodically siphoned money from the Woods' investment account to

accounts that respondent owned or controlled. He did so by repeatedly selling securities in the Woods' account so that he could acquire the proceeds. He never disclosed his activities to the Woods. By September 1990, all of the Woods' funds were gone. Pet. App. 2a, 10a, 28a-29a, 34a, 41a-42a.

In April 1995, a federal grand jury in the District of Maryland indicted respondent on thirteen counts of wire fraud in violation of 18 U.S.C. 1343. Pet. App. 2a; see *id.* at 40a-50a (Superseding Indictment). The indictment charged respondent with "devis[ing] a scheme and artifice to defraud and to obtain money and property from [the Woods] by means of false and fraudulent pretenses, representations, and promises." *Id.* at 41a. Specifically, it alleged that respondent had "caused checks to be issued against the security positions of [the Woods] and made payable to [himself], thereby causing their securities to be liquidated." *Ibid.* The indictment further alleged that respondent "sold securities in [the Woods'] joint investment account * * * and then made personal use of the money." *Id.* at 42a. A jury found respondent guilty of all of the wire fraud charges, and the district court sentenced him to 52 months in prison and ordered him to make restitution in the amount of $10,800. *Id.* at 2a. The United States Court of Appeals for the Fourth Circuit, finding "ample direct and circumstantial evidence showing that [respondent] had engaged in a scheme to defraud the Woods" (*id.* at 36a), affirmed his convictions and sentence. *Id.* at 33a-39a.

3. In September 1995, the SEC brought this civil law enforcement action against respondent in the United States District Court for the District of Maryland. Pet. App. 25a-32a. The Commission's complaint alleged that, between May and June 1988, without the Woods' knowledge or consent, respondent issued

checks to himself drawn on the Woods' joint mutual fund account, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. *Id.* at 28a. The complaint further alleged that, on several occasions between July 1988 and June 1990, respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds of the sales. *Id.* at 29a. The complaint charged that respondent thereby violated Section 10(b) and Rule 10b-5. *Id.* at 30a-31a. The Commission sought injunctive relief, including an order enjoining respondent from violating Section 10(b) and Rule 10b-5 and requiring him to disgorge the proceeds of his fraudulent conduct. *Id.* at 25a-32a.[1]

In April 1998, the Commission filed a motion for summary judgment in which it relied on the collateral estoppel effect of respondent's criminal convictions to establish that he intentionally defrauded the Woods. Respondent filed a motion to conduct discovery, but he did not move for summary judgment. In March 1999, the district court denied respondent's motion for discovery, granted the Commission's motion for summary judgment, enjoined respondent from future violations of the antifraud provisions, and ordered him to disgorge $343,000 in illegally obtained funds. Pet. App. 3a, 15a-24a.

[1] The Commission's complaint also alleged that respondent violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a). Pet. App. 25a, 30a-31a. The Commission did not seek this Court's review of the question whether the complaint stated a claim under Section 17(a) because it did not identify a square conflict between the decision of the court of appeals in this case and decisions of this Court or other courts of appeals on that question. That question is therefore not before the Court.

4. Respondent appealed. The United States Court of Appeals for the Fourth Circuit not only reversed the district court's grant of summary judgment in favor of the SEC, but also remanded the case with directions to dismiss the complaint. Pet. App. 1a-14a. As an initial matter, the court held that the district court had erred in granting summary judgment for the SEC based on collateral estoppel. *Id.* at 4a-5a. The court ruled that respondent's criminal conviction did not establish all the legal elements of the violations of Section 10(b) and Rule 10b-5 alleged in the Commission's civil complaint. In particular, the court noted that, in order to find respondent guilty of wire fraud, the jury did not need to determine that his fraud was "in connection with the purchase or sale of securities." *Id.* at 5a. Thus, the court reasoned, even if "the criminal trial established the fact that [respondent] sold securities as part of a scheme to misappropriate proceeds," respondent's criminal convictions did not collaterally estop him from contesting the district court's "legal conclusion" that "such a scheme satisfies the 'in connection with' requirement" of Section 10(b). *Ibid.*

Next, in the portion of the opinion relevant to the issue now before this Court, the court of appeals concluded that the SEC's allegations concerning respondent's scheme to sell the Woods' securities and misappropriate the proceeds did not state a claim for relief under Section 10(b) and Rule 10b-5. Pet. App. 5a-14a. The court of appeals first explained that, "to state a claim under § 10(b) of the Exchange Act and Rule 10b-5," the Commission must show that respondent's fraud was "in connection with" the purchase or sale of any security. *Id.* at 6a (quoting 15 U.S.C. 78j(b)). The court noted that the SEC "allege[d] that [respondent] defrauded the Woods by failing to inform them that he

intended to sell their securities in order to obtain the proceeds for himself." *Id.* at 8a. The court further noted that the SEC argued that this omission was fraudulent because respondent, as the Woods' agent, had a duty to disclose material information to them, and that the omission was in connection with respondent's sale of the Woods' securities. *Ibid.*

The court of appeals concluded that respondent's "alleged fraudulent activities were not sufficiently connected to a securities transaction." Pet. App. 14a. In the court's view, respondent's "securities sales were incidental to his scheme to defraud. [His] fraud lay in absconding with the proceeds of the sales. The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion." *Id.* at 9a. In explaining why it determined that respondent's conduct was not "in connection with" any securities transaction, the court stated that respondent did not mislead "the Woods about the relative merits or value of particular securities." *Ibid.* The court further noted that respondent's fraudulent "statements or omissions were not about a particular security" (*id.* at 13a), "did not make any reference to the attributes of a specific security" (*id.* at 10a), and did not "induce the Woods or anyone else to buy or sell a particular stock" (*id.* at 13a). The court also expressed the view that "the goal of § 10(b) would not be served by expanding its scope to include 'claims amounting to breach of contract or common law fraud which have long been the staples of state law.'" *Id.* at 8a (quoting *Hunt* v. *Robinson*, 852 F.2d 786, 787-788 (4th Cir. 1988)). Finally, the court observed that, "while [respondent] breached a fiduciary duty to the Woods, the Supreme Court has emphasized that the federal securities laws are not an open-ended breach of fiduciary duty

ban." *Id.* at 14a (citing *United States* v. *O'Hagan*, 521 U.S. 642, 655 (1997); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977)). The court of appeals accordingly remanded the case to the district court "with directions to dismiss it." *Ibid.*[2]

SUMMARY OF ARGUMENT

A stockbroker violates Section 10(b) and Rule 10b-5 when, without authorization or disclosure, he sells customer securities for his own benefit and converts the proceeds to his own use. The SEC has so interpreted Section 10(b) and Rule 10b-5 for over fifty years, since the Commission first promulgated Rule 10b-5, and its interpretation is consistent with the critical role of stockbrokers in the securities markets and the trust and reliance that customers place in them. See, *e.g.*, *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947).

The Commission's interpretation follows directly from the text of Section 10(b) and Rule 10b-5. Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission "in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Rule 10b-5 in turn prohibits "any person" from "employ[ing] any device, scheme, or artifice to defraud," "mak[ing] any untrue [or misleading] statement of a material fact," or "engag[ing] in any act [or] practice"

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[2] Because the court of appeals, rather than merely reversing the district court's grant of summary judgment, dismissed the Commission's complaint for failure to state a claim, this Court must assume that the allegations in the complaint are true and can affirm the dismissal only if the Commission could prove no set of facts that would entitle it to relief. See *Hartford Fire Ins. Co.* v. *California*, 509 U.S. 764, 811 (1993).

that "operates or would operate as a fraud or deceit upon any person" "in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5. In short, Section 10(b) and Rule 10b-5 encompass "(1) using any deceptive device (2) in connection with the purchase or sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997).

A stockbroker's fraudulent sales of his customer's securities and fraudulent conversion of the proceeds satisfy both of those elements. Feigning loyalty to one's principal while secretly converting the principal's property to one's own use is a well recognized form of fraud. See *O'Hagan*, 521 U.S. at 655-656; *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987). Thus, a stockbroker commits a fraud against his customers both when he secretly sells his customers' securities for his own benefit rather than for theirs, and when, while continuing his pretense of investing funds as a loyal agent and fiduciary, he embezzles the proceeds from the sales, rather than preserving his fiduciary's property.

Both the fraudulent sales of the securities and the fraudulent misappropriation of the proceeds of the sales satisfy Section 10(b)'s requirement that the fraud or deception be "in connection with the purchase or sale of any security." See *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 9-13 (1971); *O'Hagan*, 521 U.S. at 655-656. The frauds and the sales are part of the same scheme. With respect to the fraudulent sales, it is self-evident that, when a sale is itself fraudulent, the fraud is committed in connection with the sale: the wrongful sale constitutes and consummates the fraud. As regards the misappropriation of the proceeds, the sales are the means by which the stockbroker generates the cash that he intends to embezzle. Moreover, in both

cases, the stockbroker's deception directly furthers his ability to make the sales because it deprives the customers of information that could prompt them to act to prevent the sales. Finally, the stockbroker has access to the customers' assets in the first place only because they have entrusted them to him so that he can purchase and sell securities.

Interpreting the federal securities laws to prohibit this type of fundamental fraud on investors also serves the broader purposes of those laws. A principal purpose of the securities laws is "to insure honest securities markets and thereby promote investor confidence." *O'Hagan*, 521 U.S. at 658. Ensuring that stockbrokers adhere to basic standards of honesty in their dealings with customer assets is critical to that goal. Preventing stockbrokers from misappropriating customer securities and their proceeds also furthers the closely related purpose of the securities laws to protect investors from fraud. See *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979); 15 U.S.C. 78j(b). There would be a serious gap in investor protection if stockbrokers could engage in fraud against their customers that is so central to the securities trading process without violating the securities laws, which are designed to regulate the entire trading process. See 15 U.S.C. 78b. Moreover, permitting deception as basic as a stockbroker's feigning loyalty to his customer, while actually converting the customer's securities to his own purposes and misappropriating the proceeds of the securities sales, would create a significant hole in the full-disclosure regime on which the securities laws are based. See *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 477 (1977).

Decisions of this Court and other precedent confirm that violations of Section 10(b) and Rule 10b-5 may be based on fraudulent sales of securities and misappro-

priation of the proceeds of securities sales. Most notably, in *Bankers Life*, this Court held that a complaint that alleged the fraudulent misappropriation of the proceeds of a securities sale stated a cause of action under Section 10(b). 404 U.S. at 9-13. See also, *e.g.*, *United States* v. *Kendrick*, 692 F.2d 1262 (9th Cir. 1982); 7 L. Loss & J. Seligman, *Securities Regulation* 3530 & n.189 (3d ed. 1991). Because the Commission has consistently interpreted the statute and the rule to prohibit fraudulent sales of securities and misappropriation of sales proceeds, an interpretation which it has articulated in the exercise of its adjudicatory authority since shortly after the rule was first promulgated, the Commission's interpretation is entitled to deference from the courts. See *United States* v. *Mead Corp.*, 121 S. Ct. 2164, 2171-2172 (2001); *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994); *Davis* v. *United States*, 495 U.S. 472, 484 (1990).

The court of appeals erred in rejecting the SEC's interpretation based on the court's view that Section 10(b) and Rule 10b-5 prohibit only misrepresentations about particular securities and their attributes. Such a limitation is unsupported by the text of the statute and rule, is inconsistent with precedent, and would frustrate the purposes of the securities laws. See *O'Hagan*, 521 U.S. at 655-656; *Bankers Life*, 404 U.S. at 9-10. The court of appeals also erred in concluding that recognizing liability under Section 10(b) and Rule 10b-5 for fraudulent conversions of securities and embezzlement of securities proceeds would improperly federalize state law. Section 10(b) and Rule 10b-5 are properly understood to prohibit such conduct because it involves deception connected with securities transactions—the express concern of those federal provisions. See

O'Hagan, 521 U.S. at 655; cf. *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1093 n.6 (1991).

ARGUMENT

SECTION 10(b) AND RULE 10b-5 PROHIBIT A STOCKBROKER FROM FRAUDULENTLY SELLING HIS CUSTOMER'S SECURITIES FOR HIS OWN BENEFIT AND MISAPPROPRIATING THE PROCEEDS

Stockbrokers like respondent play a critical role in the investment marketplace. See D. Langevoort, *Fraud and Deception by Securities Professionals*, 61 Tex. L. Rev. 1247, 1280 (1983). They are intermediaries through whom information about the market and securities flows to individual investors. *Ibid.* & n.135; R. Pozen, *Financial Institutions: Cases, Materials and Problems on Investment Management* 175-185 (1978). The complexity of investment decision-making often requires reliance on their expertise. Langevoort, *supra*, at 1282. In addition, the stockbroker "is the person who actually trades securities for the investing public," and he "conducts himself and carries out his daily routine through the instrumentalities of the national securities exchanges and the over-the-counter market." *Rolf* v. *Blyth, Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), aff'd, 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978).

Even before the federal securities laws were enacted, state law recognized that a stockbroker generally acted as the customer's agent in executing the customer's orders for the purchase or sale of securities. C.H. Meyer, *The Law of Stockbrokers and Stock Exchanges* § 39, at 249 (1931). The law further recognized that the agency relationship between the stockbroker and customer was fiduciary in nature. *Id.* § 40, at 251.

Consequently, the stockbroker was required to act in the customer's interest and not for his own benefit, and "with the utmost good faith and integrity." *Id.* at 253.[3]

Because of the critical role that stockbrokers play in securities transactions and the special relationship between stockbrokers and investors, the federal securities laws impose extensive strictures on stockbroker conduct. See Langevoort, *supra*, at 1280 & n.135; A. Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Cornell L. Rev. 869, 871, 876-881 (1972). "There is no identifiable segment of the securities industry whose ethical conduct is more crucial to the attainment of Congress' goals than the ethical conduct of broker-dealers." *Dirks* v. *SEC*, 681 F.2d 824, 841 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646 (1983).

Against that background, the Securities and Exchange Commission, since shortly after it promulgated Rule 10b-5 in 1942, has interpreted Section 10(b) and Rule 10b-5 to prohibit a stockbroker from fraudulently misappropriating customers' securities and the proceeds of their security sales. See, *e.g.*, *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947); *Southeastern Sec. Corp.*, 29 S.E.C. 609 (1949). That interpretation reflects the

[3] When a brokerage firm sells securities owned by the firm to a customer, the firm acts as a principal rather than an agent in the sale and would not necessarily be a fiduciary with respect to the sale. Although in this case respondent was acting as the Woods' agent, see p. 15, *infra*, the Commission and the courts have long recognized that, even when brokerage firms act as principals, they implicitly represent that they will deal with clients honestly and in accordance with trade custom. See 8 L. Loss & J. Seligman, *Securities Regulation* 3772-3777 (3d ed. 1991); *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434, 435-437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

"agency relationship" between stockbrokers and customers, the customers' implicit understanding that stockbrokers will execute their transactions "honestly and in accordance with trade custom," and the "fiduciary" relationship arising out of the "trust and confidence" that customers place in their stockbrokers. *Kenneth Leo Bauer*, 26 S.E.C. at 774, 776; *Southeastern Sec. Corp.*, 29 S.E.C. at 613-614. The court of appeals erred in failing to defer to the SEC's interpretation, which follows from the text of Section 10(b) and Rule 10b-5, promotes their underlying purposes, and finds support in substantial precedent.

A. A Stockbroker's Fraudulent Sale Of Customer Securities And His Misappropriation Of The Proceeds Fall Within Section 10(b)'s Coverage Of "Deceptive Devices" Employed "In Connection With" Securities Transactions

Section 10(b) prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission "in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Section 10(b) does not require that the deception take a particular form; it prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (quoting *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); see *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Section 10(b) was framed as a "catch-all" provision to reach all "cunning devices" related to securities transactions. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202

(1976); accord *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174 (1994).

Rule 10b-5 in turn prohibits "any person" from "employ[ing] any device, scheme, or artifice to defraud," "mak[ing] any untrue [or misleading] statement of a material fact," or "engag[ing] in any act [or] practice" that "operates or would operate as a fraud or deceit upon any person" "in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5. Thus, Section 10(b) and Rule 10b-5 encompass "(1) using *any* deceptive device (2) in connection with the purchase or sale of securities." *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1997) (emphasis added).

Both those elements are satisfied here. The Commission's complaint in this case alleges that respondent, without the Woods' knowledge or consent, issued checks to himself drawn on a mutual fund account held by the Woods, and that the funds to pay the checks were obtained through the sale of mutual fund shares in that account. Pet. App. 28a. The Commission further alleges that on several occasions respondent sold mutual fund shares or other securities owned by the Woods without their knowledge or consent and misappropriated the proceeds of the sales. *Id.* at 29a. See also *id.* at 41a-42a (Superseding Indictment) (making similar allegations). That course of conduct establishes both elements of a Section 10(b) violation—(1) fraud (2) in connection with the sale of securities.[4]

[4] In a private action under Section 10(b), the plaintiff must establish not only fraud in connection with a securities transaction but also other elements. In particular, a private plaintiff (but not the government) must establish reliance (or causation) and damages. *SEC* v. *Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *SEC* v. *Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). A private plaintiff seeking damages must also establish standing under *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), as a purchaser or seller, and satisfy the pleading requirements of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737.

1. A stockbroker commits fraud when he secretly sells his customer's securities for his own benefit and when he misappropriates the proceeds of the sales

Although the court of appeals did not dispute that respondent's alleged conduct constituted fraud, understanding the nature of respondent's fraud is important in understanding how it was connected to securities sales. Respondent's conduct was fraudulent because he deceived the Woods by pretending to act as their loyal agent and fiduciary while, at the same time, he converted their assets to his own use. His fraudulent scheme involved two distinct fraudulent conversions of the Woods' property—the conversion of their securities by selling them for his own benefit rather than theirs, and the misappropriation of the proceeds of those security sales.

The Woods entrusted their assets to respondent for him to invest for their benefit in his discretion. See Pet. App. 2a; 27a-28a; see also 41a. Thus, respondent was their agent and fiduciary. See Pet. App. 14a (noting respondent's "fiduciary duty" to the Woods). As the Woods' agent and fiduciary, respondent owed them a duty of loyalty and had authority to use their assets solely for their benefit and not to enrich himself. See Restatement (Second) of Agency § 387 (1958); Restatement (Second) of Trusts § 170 (1959); see also

Restatement (Second) of Agency § 383 (duty to act only as authorized). Furthermore, respondent owed the Woods a duty to give them all information relevant to the affairs entrusted to him. See *id.* § 381.[5]

When, without disclosure to the Woods, respondent acted beyond the scope of his authority and in breach of his duty of loyalty, respondent committed fraud. As this Court explained in *O'Hagan*, "[a] fiduciary who [pretends] loyalty to his principal while secretly converting the principal's [property] for personal gain' * * * 'dupes' or 'defrauds' the principal." 521 U.S. at 653-654 (internal citation and quotation marks omitted) (second brackets added). The fiduciary's conduct constitutes embezzlement of the property entrusted to him, which has long been recognized as a form of fraud. See *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987) ("The concept of 'fraud' includes the act of embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'") (quoting *Grin* v. *Shine*, 187 U.S. 181, 189 (1902)). See also *Grin*, 187 U.S. at 189 ("it is impossible for a person to embezzle the money of another without

[5] The existence of an agency and fiduciary relationship was particularly explicit in this case, because, as both the court of appeals (Pet. App. 10a) and respondent (Br. in Opp. 13) note, respondent had discretion to engage in securities transactions on behalf of the Woods for their benefit without their prior approval. See also 8 Tr. 33-34, *United States* v. *Zandford*, Crim. No. WN-94-0165 (D. Md. July 19, 1995) (respondent's testimony and evidence that he had a general power of attorney over the affairs of William Wood). "A relationship of this sort, involving such broad authority over the customer's property, is a fiduciary one of extreme delicacy." Meyer, *supra*, § 39, at 306. Even absent such discretionary authority, however, respondent, as a stockbroker, would have a duty to his customers to adhere to his implicit representation of honest dealing. See note 3, *supra*.

committing a fraud upon him"); *Moore* v. *United States*, 160 U.S. 268, 269 (1895) ("Embezzlement is the fraudulent appropriation of property by a person to whom such property has been intrusted."). Such "misappropriation is a 'garden variety' type of fraud" that is proscribed by Section 10(b). See *Bankers Life*, 404 U.S. at 11 n.7.

As in the case of the fraudulent misappropriation of confidential information at issue in *Carpenter* and *O'Hagan*, the deception entailed in a fiduciary's misappropriation of securities or securities proceeds is inherent, because the success of the scheme depends on the agent's lulling the principal into believing that the agent is trustworthy. "The actual deception that is practised is in the continued representation of the [agent] to the [principal] that he is honest and loyal to the [principal's] interests." *United States* v. *Procter & Gamble Co.*, 47 F. Supp. 676, 678 (D. Mass. 1942). The agent's fraud can be seen either as an omission of a material fact necessary in order to make other statements made not misleading, which is prohibited by Rule 10b-5(b), or as fraudulent conduct, which is prohibited by Rule 10b-5(a) ("any device, scheme, or artifice to defraud") and Rule 10b-5(c) ("any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person"). Deceptive acts, as well as deceptive statements and omissions, have long been understood to constitute fraud. See *Shushan* v. *United States*, 117 F.2d 110, 115 (5th Cir.) ("A scheme to get money unfairly by obtaining and then betraying the confidence of another * * * would be a scheme to defraud though no lies were told."), cert. denied, 313 U.S. 574 (1941). Section 10(b) and Rule 10b-5 therefore readily apply to the fraudulent sale by a stockbroker of customer securities with which he has been entrusted

and to the stockbroker's misappropriation of the sale proceeds. The stockbroker's conduct constitutes fraud because it violates the implicit representation that he will not convert the customer's property to his own use. Cf. *O'Hagan*, 521 U.S. at 654 (implicit promise not to misuse confidential information becomes a sham when agent does so without disclosure to his principal).

Indeed, respondent's alleged conduct involved two distinct fraudulent conversions of the Woods' assets. Respondent's sale of the Woods' securities for the undisclosed purpose of benefitting himself (by furthering his plan to misappropriate the proceeds) was a fraudulent conversion and embezzlement of the securities themselves. See Meyer, *supra*, § 136, at 552 (wrongful sale of customer's securities is a conversion); *Taussig* v. *Hart*, 58 N.Y. 425 (1874) (same); *Sherman* v. *State*, 124 Tex. Crim. 205, 208 (1933) (per curiam) (agent's sale of stock with intent to misappropriate proceeds constitutes embezzlement of the stock itself). That conduct constituted fraud independently of whether respondent ultimately misappropriated the proceeds. See *United States* v. *Dunn*, 268 U.S. 121, 131 (1925) (fiduciary's "exercise of his power of disposition for his own benefit without more" is fraud); *United States* v. *Rowe*, 56 F.2d 747, 749 (2d Cir. 1932) (L. Hand, J.) ("A man is none the less cheated out of his property, when he is induced to part with it by fraud, because he gets a quid pro quo of equal value."); Meyer, *supra*, § 136, at 554 (damages for wrongful sale of customer's securities are measured by highest market value of securities within reasonable time after customer learns of sale, less amount credited to customer as a result of sale); *id.* at 557 (in stating that rule, courts "assume that the customer has been credited with the proceeds of the sale"). In addition, respondent's misappropriation of the proceeds of the

securities sales, while he pretended to act as a loyal agent and fiduciary, was a fraudulent conversion of that money. See *Bankers Life*, 404 U.S. at 10 & n.7; Meyer, *supra*, § 40, at 252; see generally *Grin*, 187 U.S. at 189 (misappropriation of money entrusted to one's care by another is a fraud).

2. A stockbroker's conversion of customer securities by means of fraudulent sales and his misappropriation of the sales proceeds are "in connection with" the sales

Respondent's alleged conduct also satisfies the requirement of Section 10(b) and Rule 10b-5 that the fraud be "in connection with the purchase or sale of any security." By its plain terms, that language requires only that there be a nexus or relationship between the fraud and a securities transaction. See *Bankers Life*, 404 U.S. at 12 (paraphrasing "in connection with" as "touching"); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 476 (1977) (quoting the "touching" language from *Bankers Life* with approval); *SEC* v. *Clark*, 915 F.2d 439, 449 (9th Cir. 1990) ("some nexus"); *Abrams* v. *Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) ("some nexus but not necessarily a direct and close relationship"); *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) ("a nexus"), cert. denied, 455 U.S. 990 (1982). The necessary connection exists "when the proscribed conduct and the sale are part of the same fraudulent scheme." *Alley* v. *Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.). Both respondent's fraudulent conversion of the Woods' securities by selling them for his own benefit and his subsequent misappropriation of the proceeds satisfy that standard.

a. As regards the fraudulent conversion of the securities themselves, there can be no question that the

fraud was "in connection with" the sales, because the sales were themselves fraudulent vis-a-vis the Woods. The sales (for the undisclosed purpose of benefitting respondent) consummated the fraud because they constituted the breach of respondent's duty of loyalty to the Woods and the fraudulent conversion of their securities. The connection between that fraud and the securities transactions is thus inherent, like the connection between the fraudulent misappropriation of confidential information and the securities transactions involved in *O'Hagan*. O'Hagan committed fraud by stealing information entrusted to him by his employer, to which he owed a fiduciary duty, and secretly using the information for personal profit by trading in securities. The Court explained that the "in connection with" requirement was satisfied in that case because "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities." 521 U.S. at 656. In this case, as in *O'Hagan*, the "securities transaction and the breach of duty thus coincide." *Ibid.*

In some respects, respondent's fraud was even more closely connected to the purchase or sale of securities than O'Hagan's. First, unlike O'Hagan, respondent did not misappropriate information and then use that information to profit from securities sales; respondent misappropriated the securities themselves, and he did so by the very act of selling them. Second, respondent deceived the owners of the securities, who were parties to the securities sales that he transacted. O'Hagan, on the other hand, deceived the owner of the confidential information, who was neither the buyer nor the seller in O'Hagan's securities transactions. See *O'Hagan*, 521 U.S. at 656 (holding that, under the misappropriation

theory of insider trading, the securities transaction and the breach of duty to disclose coincide "*even though* the person or entity defrauded is not the other party to the [securities] trade" (emphasis added)). Because O'Hagan's fraud was "in connection with the purchase or sale" of securities, respondent's fraudulent sale of the Woods' securities necessarily also had the requisite connection.[6]

Respondent's fraudulent conversion of the securities was also connected to the sales because the sales were the "direct result" of his deception. *SEC* v. *Drysdale Sec. Corp.*, 785 F.2d 38, 42-43 (2d Cir.), cert. denied, 476 U.S. 1171 (1986). If a stockbroker who was selling his customer's securities for his own benefit disclosed his intentions and actions to his customer, his customer could take steps to prevent the sales. See Langevoort, *supra*, at 1282 n.148 (describing the deception in stockbroker conversion cases as the "nondisclosure of facts sufficient to allow the client to protect his own interests by legal action or business response"). Thus, respondent's deception directly furthered his ability to make the security sales.

b. The securities sales were also an integral part of respondent's fraudulent scheme to misappropriate the proceeds of the sales. The sales were the means by which respondent accomplished the goal of that scheme. The complaint alleges that checks that respondent issued to himself drawn on the Woods' mutual fund account triggered the sale of mutual fund shares in the

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[6] The court of appeals attempted to distinguish *O'Hagan* as limited to insider trading. See Pet. App. 11a. Nothing in *O'Hagan*, however, suggests that the Court's analysis of the "in connection with" requirement was limited to insider trading cases. And nothing in the phrase "in connection with" suggests that the phrase has a special meaning in that context.

account. Pet. App. 28a. The complaint further alleges that, on repeated occasions, respondent sold mutual fund shares or other securities belonging to the Woods, caused checks to be issued in the amount of the proceeds of the sales, and deposited those checks in accounts under his control. *Id.* at 29a. In those instances, as the complaint alleges (and the court of appeals assumed), the sales were the means by which respondent "generated" the cash that he embezzled. *Ibid.*; *id.* at 2a. Thus, the fraud (the embezzlement) was "in connection with" the sales.

Indeed, respondent's fraudulent concealment of his intention to misappropriate the proceeds directly furthered his ability to make the sales that were necessary to generate those proceeds. The allegations in the complaint (which must be assumed to be true at this stage of the case, see n.2, *supra*) show that respondent had that intention at the time he made the sales. In the case of the mutual fund sales, the sales were directly and automatically triggered by respondent's act of cashing checks that he had made out to himself and that were drawn on the mutual fund account. Pet. App. 28a; see also *id.* at 41a (alleging that respondent "caused checks to be issued against the securities positions of [the Woods] and made payable to [himself] thereby causing their securities to be liquidated"). In the case of the other securities sales, respondent repeatedly sold securities and deposited checks representing the corresponding amounts of the proceeds into his personal accounts. *Id.* at 29a. The repetitive nature of the sales and subsequent conversions demonstrates that respondent intended to misappropriate the proceeds at the time that he made the sales.

The court of appeals was incorrect when it suggested (Pet. App. 12a) that respondent's misappropriation of

the proceeds of the sales of the Woods' securities is comparable to the hypothetical discussed in the opinion in *O'Hagan* of someone who "defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." *O'Hagan*, 521 U.S. at 656. The securities purchase in the hypothetical was neither necessary to nor part of the fraud. The perpetrator in the hypothetical could have used the proceeds of his fraudulent scheme to make any other purchase. In this case, in contrast, the securities transactions were integral to respondent's fraudulent scheme. Respondent could not have accomplished his fraud without the securities sales, which generated the cash that he misappropriated. Moreover, it is implicit in the hypothetical that the subsequent purchase of securities is the *only* securities transaction with which the fraud could be connected. The Court did not suggest that, if the funds embezzled were the proceeds of securities sales, the fraud could not be "in connection with" those sales.

c. There is a particularly strong connection between fraud and securities transactions when stockbrokers like respondent misappropriate securities and securities proceeds from brokerage accounts, because the very purpose of the stockbroker/customer relationship and of the brokerage account is to carry out purchases and sales of securities. The stockbroker is the critical intermediary between investors and the securities markets; it is he who "actually trades securities for the investing public." *Rolf*, 424 F. Supp. at 1036; see p. 11, *supra*. "Investors maintain * * * accounts with brokerage firms for the very purpose of trading in securities." *Angelastro* v. *Prudential-Bache Sec., Inc.*, 764 F.2d 939, 944 (3d Cir.), cert. denied, 474 U.S. 933 (1985); see also *Mihara* v. *Dean Witter & Co.*, 619 F.2d

814, 824 (9th Cir. 1980) (upholding, in a churning case, a jury instruction stating that "a broker's activities are of necessity connected with the purchase and sale of securities"); *Rolf*, 424 F. Supp. at 1036 (broker's "very employment is 'in connection with the purchase and sale of securities.'"). The stockbroker/customer relationship involves an implicit representation that the stockbroker will invest the customer's assets in securities, not convert them. See p. 18 & note 3, *supra*. The court of appeals was therefore incorrect in concluding that "[t]he misappropriated proceeds might as well have come from the unlawful sale of a car which the Woods had entrusted to [respondent's] care." Pet. App. 12a. The fact that the proceeds came from securities sales was not happenstance. Respondent had access to the Woods' assets *only because* they had entrusted those assets to him to engage in *securities transactions*. See *id.* at 2a. Thus, when respondent fraudulently misappropriated their securities and the proceeds of their securities sales, his fraud was necessarily connected to securities transactions.

B. Stockbroker Liability For Fraudulent Misappropriation Of Customer Securities And Their Proceeds Furthers Important Policies Of The Securities Laws

Interpreting Section 10(b) and Rule 10b-5 to prohibit stockbrokers from misappropriating their customer's securities and securities proceeds furthers the fundamental purposes of the federal securities laws. As this Court explained in *O'Hagan*, a principal purpose of those laws is "to insure honest securities markets and thereby promote investor confidence." 521 U.S. at 658. The securities laws seek to achieve those goals by promoting "a high standard of business ethics in the securities industry." *Basic Inc.* v. *Levinson*, 485 U.S.

224, 234 (1988); see *Herman & MacLean*, 459 U.S. at 388-389; *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979). Ensuring that stockbrokers adhere to basic standards of honesty in their dealings with customer assets is critical to that effort. As noted above, stockbrokers play a central role in enabling the participation of investors in the securities markets. Frauds by stockbrokers that impair customer assets erode investor confidence and undermine the operation of the markets.

A closely related purpose of the securities laws is to protect "[d]efrauded investors." *Herman & MacLean*, 459 U.S. at 390; see *Naftalin*, 441 U.S. at 775 ("[p]revention of frauds against investors was surely a key part" of Congress's program to regulate the securities industry); 15 U.S.C. 78j(b) (authorizing Commission to define the scope of Section 10(b) through rules "necessary or appropriate * * * for the protection of investors"). Fraudulent misappropriation of customer assets by stockbrokers is a serious and all-too-frequent form of fraud. There would be a significant gap in investor protection if stockbrokers could engage in that conduct without violating the securities laws. In fiscal year 2000 alone, the Commission brought 16 actions under Rule 10b-5 against stockbrokers for fraudulent conversion of customers' property, including securities and proceeds of sales of securities.[7]

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[7] See *David Barroso, Jr.*, Exchange Act Release No. 43,386, 73 SEC Docket 1396 (Sept. 29, 2000); *Douglas J. Hopwood*, Exchange Act Release No. 43,353, 73 SEC Docket 1125 (Sept. 26, 2000); *Cheryl A. Rodgers*, Exchange Act Release No. 43,351, 73 SEC Docket 1121 (Sept. 26, 2000); *SEC* v. *Christie*, Litigation Release No. 16,724, 73 SEC Docket 1348 (Sept. 26, 2000); *SEC* v. *Smith*, Litigation Release No. 16,698, 73 SEC Docket 910 (Sept. 12, 2000); *SEC* v. *Meridian Asset Mgmt., Inc.*, Litigation Release No. 16,638,

As the comprehensiveness of the Exchange Act makes clear, Congress intended to protect investors by regulating the *entire* securities trading process. Indeed, the Act expressly states that "transactions in securities * * * are affected with a national public interest" that makes it "necessary to provide for regulation and control of *such transactions and of practices and matters related thereto*," including the system for "settlement of securities transactions and the *safeguarding of securities and the funds related thereto*." See 15 U.S.C. 78b (emphasis added). Because the handling by stockbrokers of customer funds and securities is a critical part of the trading process, the Act "contains a number of provisions, in the nature of substantive regulation, that are designed to protect customers' funds and securities in the hands of broker-dealers." 7 L. Loss & J. Seligman, *Securities Regulation* 3107 (3d ed. 1991). It would make no sense to interpret Section 10(b), the "catch-all" antifraud provision in an act designed to regulate the entire securities trading process, including the handling by broker-dealers of customer assets, to

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72 SEC Docket 3064 (July 31, 2000); *Janney Montgomery Scott LLC*, Exchange Act Release No. 43,050, 72 SEC Docket 2663 (July 18, 2000); *Thomas V. Conwell*, Exchange Act Release No. 43,006, 72 SEC Docket 2500 (July 3, 2000); *Shan Michael Hefley*, Exchange Act Release No. 42,625, 72 SEC Docket 259 (Apr. 5, 2000); *SEC* v. *Hefley*, Litigation Release No. 16,479, 71 SEC Docket 2839 (Mar. 21, 2000); *Donald J. Martineau*, Exchange Act Release No. 42,422, 71 SEC Docket 1994 (Feb. 14, 2000); *SEC* v. *Conwell*, Litigation Release No. 16,420, 71 SEC Docket 1675 (Feb. 1, 2000); *SEC* v. *Martineau*, Litigation Release No. 16,406, 71 SEC Docket 1304 (Jan. 10, 2000); *SEC* v. *Sunpoint Sec., Inc.*, Litigation Release No. 16,366, 71 SEC Docket 464 (Nov. 19, 1999); *SEC* v. *Bulas*, Litigation Release No. 16,337, 70 SEC Docket 2887 (Oct. 15, 1999); *SEC* v. *Tropeano*, Litigation Release No. 16,327, 70 SEC Docket 2502 (Oct. 5, 1999).

exclude frauds about matters as potentially disruptive of that process as a stockbroker's scheme to misappropriate customer securities and securities proceeds.

Further, "the fundamental purpose of the 1934 Act 'to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*'" would also be eroded by the court of appeals' exclusion of respondent's fraud from the scope of Section 10(b). *Santa Fe*, 430 U.S. at 477 (citation omitted). Permitting deception on matters so central to securities transactions as those involved here—a stockbroker's feigning loyalty to his customer, while actually using the customer's securities for his own purposes and misappropriating the proceeds of the securities sales—would create a significant hole in the full disclosure regime.

Congress expressly stated in the Exchange Act itself that its intent in passing the Act, which includes Section 10(b), was to "make [securities] regulation and control reasonably complete and effective." *Herman & MacLean*, 459 U.S. at 386 (quoting 15 U.S.C. 78b). Interpreting Section 10(b) to prohibit the kinds of fraud involved in this case is critical to that goal because no other provision of the federal securities laws provides an equally effective alternative to police stockbrokers who fraudulently misappropriate customer property.[8] And the Commission's ability to take action against

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[8] Although Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), on which the Commission also relied below (see note 1, *supra*), prohibits fraud "in" the sale of securities, the conduct at issue here would not be prohibited by Section 17(a) if it is not covered by Section 10(b). See *United States* v. *Naftalin*, 441 U.S. at 773 n.4 (discussed at p. 41, *infra*). Section 15(c) of the Exchange Act, 15 U.S.C. 78*o*(c) (1994 & Supp. V 1999), prohibits brokers or dealers from engaging in fraudulent conduct only with respect to transactions in the over-the-counter market, not on exchanges.

stockbrokers absent a violation of the securities laws is limited.[9]

C. Precedent Supports Stockbroker Liability For Misappropriation of Customer Securities And Securities Proceeds

1. *This Court's decision in* Bankers Life *supports the conclusion that Section 10(b) and Rule 10b-5 are violated when a stockbroker fraudulently misappropriates customer securities and securities proceeds*

In *Bankers Life*, the Court held that a complaint that alleged the fraudulent misappropriation of the proceeds of a securities sale stated a cause of action under Section 10(b). The defendants in that case led a company's board of directors to believe that the company would receive the proceeds from a proposed sale of Treasury bonds, when in fact the defendants (who were corporate insiders and thus fiduciaries) intended to misappropriate the proceeds for their own use. 404 U.S. at 9. This Court reversed a decision of the Court of Appeals for the Second Circuit in which that court,

[9] Section 21(d)(1) of the Exchange Act, 15 U.S.C. 78u(d)(1), authorizes the Commission, in some circumstances, to bring an injunctive action based on a violation of the rules of a securities industry self-regulatory organization, such as the National Association of Securities Dealers. Section 21(f), 15 U.S.C. 78u(f), however, states that the Commission "shall not bring any action pursuant to subsection (d) * * * for violation of * * * the rules of a self-regulatory organization unless" the Commission finds that the self regulatory organization "is unable or unwilling to take appropriate action" or it is otherwise necessary or appropriate in the public interest for the Commission to bring such an action. The Commission also can bring administrative proceedings against brokerage firms and their personnel under Section 15(b)(4) and (6) and Section 21C of the Exchange Act, 15 U.S.C. 78o(b)(4) and (6), 78u-3, but only based on a violation of a provision of the securities laws, such as Section 10(b), or a criminal conviction.

much like the Fourth Circuit here, held that Section 10(b) did not apply to misappropriation of the proceeds of a sale of securities because "[t]here is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received." 430 F.2d at 360. This Court rejected that reasoning, holding that the "in connection with" requirement was satisfied when the board of directors was deceived about the reason for the sale of its securities, regardless of whether "the proceeds of the sale * * * were misappropriated." 404 U.S. at 10.

Although the Second Circuit in *Bankers Life* had acknowledged that, if the board had known that the defendants "intended to misappropriate the proceeds for their own use[,] it undoubtedly would not have authorized the sale," the court nonetheless held, like the Fourth Circuit in this case, that the fraud was not in connection with the sale of a security. 430 F.2d at 360. As the Fourth Circuit did here, the Second Circuit in *Bankers Life* reasoned that the "deception did not infect the subsequent sales transaction." *Ibid.* Compare Pet. App. 9a ("The record contains no suggestion that the sales themselves were conducted in anything other than a routine and customary fashion."). This Court rejected that reasoning and held that, although "the full market price was paid for th[e] bonds," because the board had been "duped into believing that it * * * would receive the proceeds," "[w]e cannot agree * * * that the 'purity of the security transaction and the purity of the trading process were unsullied.'" 404 U.S. at 9-10.

The court of appeals in this case attempted to distinguish *Bankers Life* on the ground that, in that case, it was the defendants' misrepresentation, rather

than an omission, that induced the securities sale. Pet. App. 13a. That purported distinction does not withstand scrutiny. Although *Bankers Life* may have involved a misrepresentation rather than, as in this case, silence in the face of a duty to disclose, that distinction is of no legal significance. Omissions are treated the same as false statements under Section 10(b) and Rule 10b-5 as long as there is a duty to disclose the information. See *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980) ("silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b)" when there is "a duty to disclose arising from a relationship of trust and confidence"); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972) (finding liability under Section 10(b) even though "these defendants may have made no positive representation or recommendation," because the "sellers had the right to know that the defendants were in a position to gain financially from their sales"). Moreover, as a practical matter, the only reason there was a misrepresentation in *Bankers Life* and an omission here is that the board needed to authorize the sale in *Bankers Life*, but the Woods had given respondent discretion to engage in securities transactions on their behalf. Accordingly, a rule that prohibited misrepresentations but not omissions would leave unprotected those brokerage customers most in need of the law's protection.

Because respondent had a fiduciary duty to the Woods, he also had a duty to disclose to them that he was selling the securities they had entrusted to him and using the proceeds for his own benefit. Further, as explained above, see p. 21, respondent's failure to disclose his plans and actions deprived the Woods of the opportunity to prevent the sales. Thus, respondent's

failure to disclose was instrumental to the sales in this case just as the misrepresentation in *Bankers Life* was instrumental to the sale in that case. Finally, the court of appeals' attempt to distinguish *Bankers Life* on the ground that respondent's deception was not "about a particular security" (Pet. App. 13a) is misplaced. The relationship between the deception and particular securities is no different here than in *Bankers Life*.[10] In any event, the scope of Section 10(b) is not restricted to misrepresentations about particular securities and their attributes. See pp. 39-43, *infra*.

Bankers Life also indicates that the fraudulent misappropriation of securities in connection with a securities transaction violates Section 10(b). In support of its holding in *Bankers Life*, this Court cited, 404 U.S. at 10-11 n.7, two lower court decisions that so held. In the first of those cases, *Allico Nat'l Corp.* v. *Amalgamated Meat Cutters of North America*, 397 F.2d 727 (7th Cir. 1968), the court of appeals "held sufficient under § 10(b) and Rule 10b-5 a complaint which charged that defendant union * * * breached a prior agreement to sell 100% of the stock in a wholly owned * * * company to plaintiffs." 404 U.S. at 10 n.7. As this Court explained, the court of appeals in *Allico* "placed primary reliance on the fact that * * * the union misappropriated some 25,000 shares of the * * * stock which had previously been sold to plaintiffs for

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[10] Although the deceptions in both this case and *Bankers Life* did not concern the *attributes* of particular securities, the deceptions in both this case and *Bankers Life* did concern *transactions* in particular securities. Respondent deceived the Woods with respect to each sale of their securities, because, with respect to each sale, he maintained the pretense that he was acting for their benefit rather than his own and that the proceeds would be used for their benefit rather than his benefit.

cash, but which were being held in escrow pending consummation of the agreement." *Ibid.* In the second of the two cases cited in the *Bankers Life* footnote, *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964), the district court held that "a conspiracy to loan plaintiff money to buy securities, followed by the misappropriation of the purchased securities when they were pledged to secure the loan, * * * violate[d] § 10(b) and Rule 10b-5." 404 U.S. at 11 n.7.

2. Other precedent supports stockbroker liability for fraudulently misappropriating customer securities and their proceeds

Several other courts of appeals have recognized that fraudulent conversion of securities and the proceeds of securities sales violates Section 10(b). For example, in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), the Ninth Circuit held that a stockbroker who converted to his own use money that he obtained from customer margin accounts that were secured by the pledge of securities engaged in fraud in connection with the sale of securities. *Id.* at 1264-1266. The stockbroker in *Kendrick* wrote checks payable to himself on the margin accounts, and those transactions were recorded as loans to the customers secured by the pledged securities. *Id.* at 1264. After explaining that a pledge of securities to secure a loan is a sale of securities within the meaning of the securities laws, see *Rubin* v. *United States*, 449 U.S. 424, 431 (1981), the court held that a sale of securities occurred each time a check was issued, because the brokerage firm each time acquired an additional interest in the pledged securities. 692 F.2d at 1265. The court next explained that the stockbroker engaged in fraud because he "failed to disclose to his customers * * * that he was acting

beyond his authority in using customer funds for his own use." *Id.* at 1265-1266. Finally, the court concluded that the fraud was "in connection with" the sales because the stockbroker was engaged in the fraud at the time he caused the brokerage firm to issue the checks on the margin accounts, which was the time at which the sales occurred. *Ibid.*

Other courts of appeals have found Section 10(b) violations in similar circumstances. See *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1027-1029 (6th Cir. 1979) (brokerage firm's fraudulent conversion of bonds that customer had pledged to the firm as collateral violated Section 10(b)); *SEC* v. *Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1094-1095 (2d Cir. 1972) (Section 10(b) violated by "misappropriation of the proceeds" of an initial public offering by retaining funds paid by investors when the precondition for retaining the proceeds had not been met); *Richardson* v. *MacArthur*, 451 F.2d 35, 39 (10th Cir. 1971) (seller's scheme to defraud buyer by converting stock after the sale violates Section 10(b)); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.) (allegation that brokerage firm knew of and facilitated another stockbroker's scheme to convert the securities investment funds of its customers states a claim under Section 10(b)), cert. denied, 396 U.S. 838 (1969).[11]

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[11] The Second Circuit has held that a fiduciary's fraudulent conversion of stock several months or years after the stock is purchased is not "in connection with" the earlier purchase. See *Flickinger* v. *Harold C. Brown & Co.*, 947 F.2d 595 (1991); *Pross* v. *Katz*, 784 F.2d 455 (1986). Even if we assume, *arguendo*, that those decisions were correct, they differ significantly from this case because respondent's fraudulent conversion of the Woods' securities was consummated by their sale. See p. 20, *supra*. In any event,

The leading commentators also agree that Section 10(b) is violated by a stockbroker's fraudulent sale of a customer's securities or conversion of the proceeds of securities sales. See 7 L. Loss & J. Seligman, *Securities Regulation* 3530 & n.189 (3d ed. 1991); 5B A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 38.01[b], at 2- 55 (1996); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 67.02, at 3-760 to 3-761 (1999); *id.* § 213.02, at 9-187 to 9-192, 9-197 (2001); 4 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud*, § 15.07(215)(3), at 15:162 (2d ed. 2000). See also L. Lowenfels & A. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 Business Lawyer 1, 16 (2001) (noting, in discussing this case, that "[i]t is hard to understand how [respondent's] activities did not constitute fraud 'in connection with' the sale of a security").

D. The SEC's Contemporaneous And Consistent Interpretation Of Section 10(b) And Rule 10b-5 Is Entitled To Deference

The SEC has interpreted Section 10(b) and Rule 10b-5 to prohibit the fraudulent misappropriation by

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the mere passage of time between the securities transaction and the misappropriation does not preclude Section 10(b) liability. See 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 4.7(574)(3), at 88.35 (2d ed. 2001) (necessary connection exists "if the plaintiff can trace the proceeds or show a plan to misappropriate conceived at or near the sale"). In *Hunt* v. *Robinson*, 852 F.2d 786, 787 (1988), the Fourth Circuit held that an alleged fraudulent stock transaction was not actionable under Section 10(b) because the claim amounted to "common law fraud." As discussed below, however, the fact that an alleged fraud in connection with a securities transaction is also redressable under state law does not preclude liability under Section 10(b). See pp. 46-48, *infra*.

broker-dealers and their employees of customer securities and the proceeds of securities sales since the Commission first promulgated Rule 10b-5 in 1942. As the Commission emphasized in its brief amicus curiae in *Bankers Life*, "almost since the Commission was established, application of the antifraud provisions of the Securities Act and the Securities Exchange Act to the misappropriation of investors' funds has been particularly prominent in its regulation of brokers and dealers registered with it." SEC Br. at 19-20. See also *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964) (discussed in *Bankers Life*, 404 U.S. at 11 n.7, and at p. 32, *supra*) ("such activity has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5").[12]

For example, in *Kenneth Leo Bauer*, 26 S.E.C. 770 (1947), the Commission found a violation of Rule 10b-5 because the firm misappropriated to its own use securities and the proceeds of the sales of securities that customers had entrusted to the firm with the understanding that they would be sold and the money transmitted to the customers, as well as money customers had entrusted to the firm for the purpose of purchasing securities. *Id.* at 773, 775. The Commission noted that the firm was acting as the agent of the customers. *Id.* at 774. It characterized the firm's conduct as "the crudest and most flagrant type of scheme to obtain customers' funds and securities under false

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[12] Even before the promulgation of Rule 10b-5, the Commission had interpreted Section 17(a) of the Securities Act of 1933 to prohibit such stockbroker fraud. See *SEC* v. *Lawson*, 24 F. Supp. 360 (D. Md. 1938); *Globe Sec. Co.*, 10 S.E.C. 1105, 1109, 1110 (1942). As noted above, Section 17(a) is not directly at issue here, and respondent's conduct would not be prohibited by Section 17(a) if it is not covered by Section 10(b). See notes 1, 8, *supra*.

pretenses." *Id.* at 776. And it held that the misappropriations "violated the implicit representation that [the firm] would either execute transactions honestly and in accordance with trade custom or return the customers' funds." *Ibid.*

Similarly, in *Southeastern Securities Corporation*, 29 S.E.C. 609 (1949), the Commission found a violation of Rule 10b-5 because the president and director of a brokerage firm sold a customer's securities without her knowledge or consent and converted the proceeds of the sale to his own use. *Id.* at 611-612. The Commission noted that the relationship between the stockbroker and the customer was founded on "trust and confidence" and that his "duty as a fiduciary was to exert his most diligent and conscientious efforts in her interests and to subordinate his own." *Id.* at 613-614. Although the stockbroker argued that his conduct was authorized because he had discretion over the customer's affairs by virtue of a general power of attorney, the Commission rejected that argument. *Id.* at 614. The Commission explained that, "[e]ven assuming the existence and validity of the alleged power of attorney, [the stockbroker's] use of [the customer's] money for his purely personal benefit would not be authorized by that instrument in the absence of a showing of full and specific disclosure to, and understanding and consent by," the customer. *Ibid.* The Commission therefore concluded that the stockbroker's "taking and sale of [the customer's] securities and his use of the proceeds constituted a willful abuse of his trust" and a violation of Section 10(b) and Rule 10b-5. *Ibid.*[13]

[13] See also, *e.g.*, *D.S. Waddy & Co.*, 30 S.E.C. 367 (1949); *Calvert Sec. Corp.*, 35 S.E.C. 141, 143 (1953); *Stuart F. Beck*, Exchange Act Release No. 19,916, 28 SEC Docket 303 (June 27, 1983); *SEC v. Faitos*, Litigation Release No. 12,786, 48 SEC Docket 528 (Feb. 27, 1991); *SEC* v. *Harris*, Litigation Release No. 16,954, 74 SEC Docket 2058 (Apr. 6, 2001).

The interpretation of Section 10(b) and Rule 10b-5 embodied in those and similar adjudicatory decisions by the SEC is entitled to deference. Section 10(b) is not self-executing, but rather provides that the use of deceptive devices in connection with securities transactions is unlawful when it is "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). Thus, Congress did not itself attempt to catalogue all the deceptive and manipulative devices and practices prohibited under Section 10(b), but vested "broad discretionary powers in the [SEC]" to define that conduct. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934). The SEC has exercised that broad authority by promulgating Rule 10b-5. See 17 C.F.R. 240.10b-5. The construction of Section 10(b) reflected in Rule 10b-5 "is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." See *United States* v. *Mead Corp.*, 121 S. Ct. 2164, 2171 (2001). The SEC's interpretation of Rule 10b-5 must in turn "be given controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994) (quotation marks omitted).

In addition to giving the Commission express authority to define the scope of Section 10(b) through rulemaking, Congress has authorized the SEC to interpret Section 10(b) and Rule 10b-5 through adjudication. The Exchange Act authorizes the Commission to determine through formal adjudication whether

brokers and dealers have willfully violated the federal securities laws and the rules and regulations promulgated thereunder. See 15 U.S.C. 78o(b)(4)(D) and (6)(A)(i). "It is fair to assume that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force." *Mead*, 121 S. Ct. at 2172. Thus, the SEC's reasonable interpretation of Section 10(b) and Rule 10b-5 "promulgated in the exercise of that authority" must be given effect by the courts. *Id.* at 2171, 2172. See generally *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-844 (1984).

Substantial deference to the Commission's interpretation would be warranted here even absent the delegations of authority in Section 10(b) and other provisions of the Exchange Act to issue interpretations having the force of law. As noted above, the Commission adopted its interpretation in the years immediately following the promulgation in 1942 of Rule 10b-5, and the Commission has consistently adhered to that interpretation since that time. Considerable weight is due "a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new." *Norwegian Nitrogen Prods. Co.* v. *United States*, 288 U.S. 294, 315 (1933). See, *e.g.*, *Good Samaritan Hosp.* v. *Shalala*, 508 U.S. 402, 414 (1993); *Davis* v. *United States*, 495 U.S. 472, 484 (1990); *Edward's Lessee* v. *Darby*, 25 U.S. (12 Wheat.) 206, 210 (1827). "Moreover, such a contemporaneous construction deserves special deference when it has remained consistent over a long period of time." *EEOC* v. *Assoc.*

Dry Goods Corp., 449 U.S. 590, 600 n.17 (1981); see *Davis*, 495 U.S. at 484. See also, *e.g.*, *Udall* v. *Tallman*, 380 U.S. 1, 15 (1965) (applying same principle to interpretation of regulation). There is no reason to depart now from the Commission's contemporaneous and longstanding interpretation of Section 10(b) and Rule 10b-5, which, as described above, is consistent with the text and purposes of those provisions, as well as this Court's precedent.

E. The Court Of Appeals Erred In Engrafting On Section 10(b) And Rule 10b-5 Limitations That Do Not Appear In Their Text

1. Section 10(b) and Rule 10b-5 are not limited to misrepresentations about particular securities or the value or other attributes of particular securities

The court of appeals erred in reasoning that respondent's fraud did not have the requisite connection to a securities transaction because respondent did not mislead "the Woods about the relative merits or value of particular securities" (Pet. App. 9a), his misrepresentations "did not make any reference to the attributes of a specific security" (*id.* at 10a), and they "were not about a particular security" (*id.* at 13a). As explained above, respondent deceived the Woods with respect to each sale of their securities. See p. 31 & note 10, *supra*. Moreover, Section 10(b) and Rule 10b-5 require only that fraud be "in connection with" a securities transaction. That language does not impose a limitation on the subject matter of the prohibited deception.

"Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a

10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.'" *A.T. Brod & Co.*, 375 F.2d at 396-397.[14] See *SEC* v. *Jakubowski*, 150 F.3d 675, 679-680 (1998) (Easterbrook, J.), cert. denied, 525 U.S. 1103 (1999). Thus, in *O'Hagan*, the misrepresentation was (like the misrepresentation in this case) the fiduciary's false profession of his intent to honor his duty of loyalty to his principal, 521 U.S. at 653-654. In *Bankers Life*, the misrepresentation was that the seller of the securities would receive the sales proceeds, which is also an implicit misrepresentation in this case. 404 U.S. at 9-10. In neither *O'Hagan* nor *Bankers Life* did the deception concern the value or other attributes of a particular security.

Similarly, in *Naftalin*, this Court held that the defendant's misrepresentation about his intention and ability to sell securities violated Section 17(a) of the Securities Act of 1933, which prohibits fraud "in the offer or sale of any securities." 15 U.S.C. 77q(a). The defendant falsely represented that he owned stock that he entered into a contract with a broker-dealer to sell; in fact, he did not own the stock, and he was unable to deliver it because the price rose before the settlement date. 441 U.S. at 770-771 . The Court's conclusion that a misrepresentation concerning the ability and intention to deliver stock can form the basis for liability under Section 17(a) is instructive with respect to the scope of Section 10(b), because Section 17(a)'s prohibition on

[14] The Court in *Bankers Life* discussed this aspect of *A.T. Brod & Co.*, noting with apparent approval that the Second Circuit had reversed the dismissal of the complaint even though "no fraud [was] alleged as to the investment value of the securities." 404 U.S. at 11 n.7 (quoting 375 F.2d at 396).

fraud "in the offer or sale of any securities" is analogous to Section 10(b)'s prohibition on fraud "in connection with the purchase or sale of securities." See *Herman & MacLean*, 459 U.S. at 383 (characterizing *Naftalin* as "applying § 17(a) of the 1933 Act to conduct also prohibited by § 10(b)"); *Naftalin*, 441 U.S. at 773 n.4 (suggesting that "in" and "in connection with" are coterminous); *Hochfelder*, 425 U.S. at 213 n.32 (noting substantial overlap between text of Rule 10b-5 and Section 17). The broad language of Section 10(b) and Rule 10b-5, like the broad language in Section 17(a), is "expansive enough to encompass the entire selling process" and "does not require that the fraud occur in any particular phase of the selling transaction." *Naftalin*, 441 U.S. at 773.

Consistent with the statutory and regulatory texts, as well as this Court's precedent, the courts of appeals also have frequently found the "in connection with" requirement satisfied in cases in which the misrepresentation did not concern the value or any other attribute of a particular security. See *Press* v. *Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (broker-dealer's failure to disclose to a customer purchasing a Treasury note that funds from the maturing note would not be available on the maturity date); *Jakubowski*, 150 F.3d at 679 (purchaser's misrepresentation of his identity); *Angelastro* v. *Prudential-Bache Sec., Inc.*, 764 F.2d 939 (3d Cir.) (misrepresentations about the interest rates on a margin account), cert. denied, 474 U.S. 935 (1985); *Marbury Mgmt., Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.) (securities salesman's fraudulent representation that he was a licensed registered representative when he was only a trainee), cert. denied, 449 U.S. 1011 (1980); *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith*, 651 F.2d 615 (9th Cir.

1981) (misrepresentation of the risks of buying securities on margin in a declining market); *Fey* v. *Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974) (churning of customer accounts).[15]

Congress's purposes in enacting a broad antifraud provision like Section 10(b) would be seriously undermined by a rule that Section 10(b) encompasses only misrepresentations about the value or another attribute of a particular security. Such an interpretation would remove from the statute's purview many pernicious forms of fraud. For example, it would call into question the misappropriation theory of insider trading upheld in *O'Hagan*. Moreover, it would exempt from Section 10(b)'s coverage many types of fraud perpetrated by stockbrokers against their customers, in addition to fraudulent misappropriation of customer securities and their proceeds. As indicated by the cases cited above, deceptive conduct by stockbrokers frequently includes churning customer accounts and other misrepresentations about the trading process. See, *e.g.*, *Angelastro*, 764 F.2d at 943 (relying on decisions including "fraud involving the [securities] trading process" as within "the scope of section 10(b) and Rule 10b-5" to conclude

[15] In *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984), on which the court of appeals in this case relied (Pet. App. 7a, 10a), the Second Circuit suggested that only misrepresentations about the securities involved in a particular transaction could be "in connection with the purchase or sale" of securities. See 726 F.2d at 943. In subsequent cases, however, the Second Circuit has made clear that the "in connection with" requirement does not place a subject matter limitation on the misrepresentations that are actionable under Section 10(b). See, *e.g.*, *Drysdale Sec. Corp.*, 785 F.2d at 42-43 (holding that a misrepresentation about the financial condition of the seller was actionable under Section 10(b) when "securities were transferred as a direct result of [the] misrepresentation").

that a stockbroker's misrepresentation of the interest rates on a margin account violates Section 10(b)); *Mihara*, 619 F.2d at 824 (rejecting contention that, in a churning case, fraud must be shown in connection with each trade). Exempting those frauds from Section 10(b)'s coverage would directly frustrate Congress's intent to protect investors, achieve the highest standard of honesty in the securities industry, and safeguard securities and funds related to securities transactions. See pp. 24-27, *supra*. It would also be contrary to Congress's expressed concern in enacting the Exchange Act to remedy the "disregard of trust relationships by those whom the law should regard as fiduciaries" in the context of securities transactions. *Bankers Life*, 404 U.S. at 11-12 (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934)).

2. Applying Section 10(b) and Rule 10b-5 to a stockbroker's fraudulent conversion of customer securities and their proceeds would not improperly federalize state law

a. The court of appeals also erred in concluding that respondent's fraudulent sales of the Woods' securities and embezzlement of the proceeds of the sales constituted only conversion or theft, in violation of state law, and not securities fraud. See Pet. App. 12a, 14a. A stockbroker's embezzlement or fraudulent misappropriation of securities and their proceeds differs from simple conversion or theft, because the stockbroker's actions involve *fraud* or *deception* in connection with a securities transaction. See pp. 15-19, *supra*. Conversion or theft, in contrast, need not involve deception but only the taking of property belonging to another. See Restatement (Second) of Torts § 222A(1) (1977) ("Conversion is an intentional exercise of dominion or control

over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel."); *United States* v. *Corona-Sanchez*, 234 F.3d 449, 454 (9th Cir. 2000) (noting that "[t]he contemporary crime of 'theft' stems from the common law crime of larceny," which was "when one person misappropriated another's property by means of taking it from his possession without his consent"). Because Section 10(b) "trains on conduct involving manipulation or deception" "in connection with the purchase or sale of any security," a Section 10(b) action that is premised on deception does not improperly federalize state law. *O'Hagan*, 521 U.S. at 655.

In *O'Hagan*, the Court held that a fiduciary's misappropriation of his principal's confidential information is a violation of Section 10(b) when the fiduciary "feign[s] fidelity" to the principal. 521 U.S. at 655. As in *O'Hagan*, respondent here feigned fidelity to his principals while, at the same time, he misappropriated the property they had entrusted to him. See pp. 15-19, *supra*. Thus, like the conduct in *O'Hagan*, respondent's fraud falls squarely within the conduct prohibited by Section 10(b) and Rule 10b-5.

Other decisions of this Court confirm that situations that are generally the concern of state law also become the special concern of the federal securities laws when they involve deception connected with securities transactions. For example, in *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1090-1098 (1991), the Court held that misrepresentations about internal corporate affairs may be actionable under the federal securities laws when deception is involved, even though corporate mismanagement is generally governed by state law. In addition, in *The Wharf (Holdings) Limited* v. *United*

International Holdings, Inc., 121 S. Ct. 1776, 1782 (2001), the Court rejected the argument that a claim that a corporation sold an option contract with the secret intent not to honor the option was an "ordinary state breach-of-contract claim * * * outside the [Exchange] Act's basic objectives."

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977), on which the court of appeals relied here (Pet. App. 14a), is not to the contrary. As this Court explained in *O'Hagan*, there was no deception in *Santa Fe*. See 521 U.S. at 655. *Santa Fe* involved a claim that the defendant majority shareholder, although it made full disclosure, breached its fiduciary duty to minority shareholders in a freeze-out merger. The Court ruled that that claim, standing alone, did not state a cause of action under Section 10(b). The primary basis for that holding was not that the case involved issues traditionally governed by state law, but that "the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative." 430 U.S. at 474. The Court in *Santa Fe* pointed out the difference between the situation there, which involved only a breach of fiduciary duty by the majority shareholders, and cases "in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception." *Id.* at 474-475 & n.15 (citing, *inter alia*, *Bankers Life*).

In distinguishing *Santa Fe* in *Virginia Bankshares*, the Court explained that, although state law governs internal corporate affairs, Section 14(a) of the Exchange Act, which governs proxy solicitations, "does impose responsibility for false and misleading proxy statements." 501 U.S. at 1093 n.6. The Court further explained that, "[a]lthough a corporate transaction's 'fairness' is not, as such, a federal concern, a proxy statement's claim of fairness presupposes a factual integrity

that federal law is expressly concerned to preserve." *Ibid.* The same analysis applies to Section 10(b) actions involving conversion: Simple conversions of money and property, as such, are not the concern of Section 10(b). When those conversions involve deception in connection with a securities transaction, however, they become the concern of Section 10(b), because that provision is expressly designed to prohibit fraud connected with securities transactions.

b. When a stockbroker embezzles customer property, the customer likely has a state law claim for fraud as well as a claim under Section 10(b). The court of appeals erred, however, in suggesting that the existence of a fraud remedy under state law precludes liability under Section 10(b). See Pet. App. 8a, 14a. Section 10(b) and Rule 10b-5 contain no language excluding from their coverage frauds that are actionable under state law. In addition, Section 28(a) of the Exchange Act expressly provides that, with certain exceptions not relevant here, "[t]he rights and remedies provided by [the Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. 78bb(a) (Supp. V 1999).

More fundamentally, creating an exception from liability under Section 10(b) for common law fraud would eliminate Section 10(b) as a meaningful check on securities fraud, because most allegations of deception in connection with the purchase or sale of securities also support state law fraud claims. See *Madison Consultants* v. *FDIC*, 710 F.2d 57, 66 (2d Cir. 1983) (observing that if "Rule 10b-5 provide[d] relief only when state remedies are unavailable" it "would eviscerate the Rule" because state common law remedies permit recovery in most if not all areas covered by Rule 10b-5); 5A A. Jacobs, *Litigation and Practice Under*

Rule 10b-5, § 11.01, at 1-323 (1996) ("Common law and 10b-5 both provide relief for the same wrong—in other words, * * * that common law permits recovery will not bar a 10b-5 suit.").

Although the Court in *Santa Fe* expressed concern over the unwarranted encroachment of federal law into areas traditionally regulated by state law, that concern arose from the prospect of federal regulation *absent deceptive conduct*. See 430 U.S. at 478-479 (absent deception, federal action could "interfere" with or "overrid[e]" state law and policies). The Court recognized that "the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy." *Id.* at 478.

Thus, the Court has repeatedly found violations of Section 10(b) and Rule 10b-5 in cases in which there were also likely fraud remedies under state law. See *The Wharf (Holdings) Ltd.*, 121 S. Ct. at 1780; *O'Hagan*, 521 U.S. at 655; *Bankers Life*, 404 U.S. at 12. In those cases, as in this one, "[s]ince there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under [Section] 10(b), whatever might be available as a remedy under state law." *Ibid.*

Finally, it would make little sense to interpret the federal securities laws to cover highly technical fraudulent schemes that might not be reached by state common law but not to cover bold, straightforward fraudulent schemes long forbidden by state law. The primary federal role in regulating the national securities markets would be compromised by a regime that precluded the federal government from attacking the most outrageous and obvious frauds. See *SEC* v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995) (Posner, J.) ("It

would be a considerable paradox if the worse the securities fraud, the less applicable the securities laws."). In 1947, the Commission recognized that schemes like respondent's are "the crudest and most flagrant type of scheme to obtain customers' funds and securities under false pretenses." *Kenneth Leo Bauer*, 26 S.E.C. at 776. Over 50 years later, that conduct still violates the federal securities laws.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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* The Solicitor General is recused in this case.